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National Credit Union Administration (NCUA) has requested public comments on whether and how odify its Supervisory Committee audit rules in relation to issues detailed in the request.

ched are my comments to 7535-01-U, issued by NCUA as an Advance Notice of Proposed making related to 12 C.F.R. parts 704, 715 and 741, Supervisory Committee Audits. My ments/response follows each of your questions:

ternal Control Assessment and Attestation

. **Should part 715 require, in addition to a financial statement audit, an "attestation on internal controls" over financial reporting above a certain minimum asset size threshold? Explain why or why not.**

Not necessarily. The factors existing in the public marketplace relating to fraudulent manipulation of income to meet shareholder or market expectations are not as strong in credit unions. Credit unions are not reliant on the public market for a significant source of capital funding. In addition, incentive compensation plans, although existing for senior management personnel in certain credit unions, are not generally as significant a portion of the total compensation as can occur in public companies.

What minimum asset size threshold would be appropriate for requiring, in addition to a financial statement audit, an "attestation on internal controls" over financial reporting, given the additional burden on management and its external auditor? Explain the reasons for the threshold you favor.

The concern addressed by both Sarbannes-Oxley, related to public companies, and FDICIA, related to non-public banks in excess of $1 billion in assets, is to provide further protection to the public against potential internal fraud. A similar asset base for implementation of this requirement could be used for credit unions as non-public banks. For some concerned parties this would be a move toward leveling the playing field in the market place.

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Other "outside the box" options to protect the public investor/member may include implementation of the requirement for an "attestation on internal controls" if uninsured deposits are in excess of a set amount and/or; assessment of an annual insurance premium, above the maintenance of a deposit in the NCUSIF for entities over a set dollar amount of assets.

An additional consideration would be, based upon credit union risk-based or GAAP capital levels exceeding some benchmark wherein adequate protection is deemed provided to the Credit Union's members and to the NCUSIF, waive the "attestation on internal controls" requirement.

A. Internal Control Assessment and Attestation

3. **Should the minimum asset size threshold for requiring an "attestation on internal controls" over financial reporting be the same for natural person credit unions and corporate credit unions? Explain why.**

   Not necessarily. Corporate credit unions have much fewer members than natural person credit unions. In addition individual persons are not members of corporate credit unions. The inherent oversight of the SOX requirements seems to be designed to protect investors that lack adequate resources, or access, to become informed of, or recognize the potential for organizational internal control deficiencies or weaknesses. As a result the need for this level of additional oversight is significantly lessened in the corporate credit union environment.

4. **Should management's assessments of the effectiveness of internal controls and the attestation by its external auditor cover all financial reporting, (i.e., financial statements prepared in accordance with GAAP and those prepared for regulatory reporting purposes), or should it be more narrowly framed to cover only certain types of financial reporting? If so, which types?**

   Currently, for credit unions with total assets exceeding $10 million, the regulatory reported financial data is to be in accordance with generally accepted accounting principles (GAAP). Based on this, the assessment of the effectiveness of internal controls and the attestation by the external auditor would appear to be able to be accomplished on a cost effective basis simultaneously for both GAAP financial statements and regulatory reported financial statements.

5. **Should the same auditor be permitted to perform both the financial statement audit and the "attestation on internal controls" over financial reporting, or should a credit union be allowed to engage one auditor to perform the financial statement audit and another to perform the "attestation on internal controls?" Explain the reasons for your answer.**

   To maximize efficiency and reduce the burden of compliance the same auditor should be permitted to perform both the financial statement audit and the "attestation on internal controls" over financial reporting as the financial statement auditor will have attained a significant understanding of the financial reporting process in their process. Requiring separation of these roles would result in duplication of costs to the credit union. However, if a credit union wishes to separate these functions it should be permitted.

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6. **If an "attestation on internal controls" were required of credit unions, should it be required annually or less frequently? Why?**

This depends upon the requirements ultimately established for Question No. 5 above. If the same firm was permitted to perform both the financial audit and the "attestation on internal controls", (once the control environment was properly established and procedures established to document performance of the controls and ongoing monitoring) there exists some potential for efficiency in completing the annual audit report and the "attestation on internal controls" at the same time.

Internal Control Assessment and Attestation

If the requirements ultimately require a separation of these two roles it may be functional to require the "attestation on internal controls" only every third year or on a basis that SAS 70 audits have been performed in the market place.

7. **If an "attestation on internal controls" were required of credit unions, when should the requirement become effective (i.e., in the fiscal period beginning after December 15 of what year)?**

There would need to be a phase in period as has been the case with public and other companies, initially providing a deadline for the establishment of the control processes and documentation. In the year subsequent to the initial deadline the "attestation" could be performed. Phase 1 could potentially be slated for years beginning after December 15, 2007 with Phase 2 being required the subsequent year.

Standards Governing Internal Control Assessments and Attestations

8. **If credit unions were required to obtain an "attestation on internal controls," should part 715 require that those attestations, whether for a natural person or corporate credit union, adhere to the PCAOB's AS 2 standard that applies to public companies, or to the AICPA's revised AT 501 standard that applies to non-public companies? Please explain your preference.**

As neither the natural person, or corporate credit unions are public companies, adherence to the AICPA's revised AT 501 standard would be appropriate.

9. **Should NCUA mandate COSO's *Internal Control – Integrated Framework* as the standard all credit union management must follow when establishing, maintaining and assessing the effectiveness of the internal control structure and procedures, or should each credit union have the option to choose its own standard?**

A standard should be established by NCUA to create consistency in the market.

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C. Qualifications of Supervisory Committee Members

10. **Should Supervisory Committee members of credit unions above a certain minimum asset size threshold be required to have a minimum level of experience or expertise in credit union, banking or other financial matters? If so, what criteria should they be required to meet and what should the minimum asset size threshold be?**

This issue is inherently entangled with the fact that the Credit Union Supervisory Committee members can not be compensated. In reality every Supervisory Committee should have at least one member who has banking, financial management, or accounting expertise. Without this expertise the Committee's ability to assess processes used or financial operating results or other data presented to them is severely limited.

As the Credit Union asset size grows the fiduciary responsibility assumed by the Committee also grows. In smaller credit unions, those under $10-15 million in assets, the Supervisory Committee has responsibility for performing many of the ongoing and annual audit functions that occur. Credit unions with greater than $10-15 million in assets frequently outsource at least the annual audit function. Those over $75 million, or with several operating locations, will frequently have an internal auditor or outsource internal audit functions in addition to having annual audit.

As the credit union grows in asset size the Committee's role migrates from "being" the audit function to one of "managing" the audit function. The skill set required of the Committee member changes as well in conjunction with this migration of responsibility. The skill set required of a Committee managing an outsourced internal audit function (or an internal auditor) and the outsourced annual opinion audit includes accounting/auditing, human resource, time management, negotiating skills, and financial management skills.

How much less is the skill set needed in the Committee members in a $150 million credit union than in a $500 million, $750 million, or $1 billion credit union? The skill set needed marginally differs as the assets grow. What does change is the dollar amount of fiduciary responsibility assumed, the depth, diversity, knowledge and personalities of the management team being interacted with, and the complexity of management practices that the committee member needs to be able understand.

In summary, requiring banking or related financial management expertise does only addresses some of the skills the Supervisory Committee may need in the larger credit unions.

11. **Should Supervisory Committee members of credit unions above a certain minimum asset size threshold be required to have access to their own outside counsel? If so, at what minimum asset size threshold?**

Many larger credit unions have internal legal counsel that work closely with the Supervisory Committee and management. Obviously, because of the close working relationship with management, they may not be independent in their dealings with the Committee.

Access to outside counsel would be beneficial to Supervisory Committees, not because they have a frequent need for it, but, because when it is needed there is no pre-existing arrangement in place to facilitate it happening. In addition to pre-establishing an arrangement the Credit Union Board should pre-authorize an amount that could be spent prior to having to come back to the Board for more funding.

Defining the appropriate asset size to require this is difficult as the issues that arise are not contingent upon asset size. The need for access to legal counsel is usually a result of inadequate management response to issues that have been raised either by credit union employees, members, examiners, outside auditors, or the Committee itself.

2. Should Supervisory Committee members of credit unions above a certain minimum asset size threshold be prohibited from being associated with any large customer of the credit union other than its sponsor? If so, at what minimum asset size threshold?

To appropriately perform their duties Supervisory Committee members should be seen as independent and also be independent in fact. This would include independence not only from significant customers but also vendors and employees of the credit union.

Asset size does not impact the need for independence.

3. If any of the qualifications addressed in questions 10, 11 and 12 above were required of Supervisory Committee members, would credit unions have difficulty in recruiting and retaining competent individuals to serve in sufficient numbers? If so, describe the obstacles associated with each qualification.

The requirement that would make it most difficult to recruit Committee members is No. 10 related to the experience qualifications as it immediately reduces the eligible pool of volunteers dramatically. Individuals who understand the role of the Committee and understand financial accounting are the ones who have historically taken their volunteer responsibility most seriously. Permitting compensation of Committee members may increase the number of those with adequate experience qualifications that are willing to serve. Items No. 11 and 12 would only have a negligible impact on recruiting or retaining individuals as the issues they address are not the norm but rather a small exception in the market.

<u>dependence of State-Licensed, Compensated Auditors</u>

4. Should a State-licensed, compensated auditor who performs a financial statement audit and/or "internal control attestation" be required to meet just the AICPA's "independence" standards, or should they be required to also meet SEC's "independence" requirements and interpretations? If not both, why not?

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The SEC requirements differ from the AICPA's in the areas of not permitting performance of certain consulting services while also performing the audit, requiring periodic audit partner rotation and considering it a conflict of interest when an audit firm employee who worked on the prior audit goes to work for the client in a key position that could influence the audit, within one year of the current audit period. For situations where just the financial statement audit is performed the AICPA standard requiring oversight and management of consulting engagements with the decision process being that of management is adequate. Periodic partner rotation may be difficult in markets where audit service providers are limited or the size of the firm may not permit rotation within the firm. Prohibiting credit unions from hiring an audit firm from whom they have recently recruited management talent also may be difficult in smaller markets. Multiple year fee quotes and engagement contracts, with discounted fees for the multiple years, would need to have penalty clauses in the event of early cancellation of the contract due to the credit union's hiring action causing a lack of independence. If an "attestation on internal controls" is being provided (which is generally only going to apply to larger credit unions), whether in conjunction with the financial opinion audit or alone, the first and third area of the SEC expanded independence rules should be applied to ensure the internal control environment being attested to was not designed and/or established by the opining firm and to ensure that no recent hiring would present a conflict of interest for this service deemed important for this large credit union.

E. Audit Options, Reports and Engagements

15. Is there value in retaining the "balance sheet audit" in existing §715.7(a) as an audit option for credit unions with less than $500 million in assets?

The "balance sheet audit" option for credit unions with assets less than $500 million has value in certain key scenarios as follows: in the initial opinion audit year of an entity it precludes the necessity to audit both the beginning of the year and end of the year balances and thus save the credit union audit costs; in the event of mergers under pooling accounting (potentially going away soon) where the perceived benefit of combining all prior periods presented in accordance with generally accepted accounting practices is out weighed by the estimated cost; and for smaller entities that switch back and forth to save audit costs between the "minimum agreed upon procedures engagement" in years when member verifications are not required and the "balance sheet audit" in years when this additional procedure is required. With the future requirement of purchase accounting on mergers this option could be limited to credit unions with assets of less than $100 million.

16. Is there value in retaining the "*Supervisory Committee Guide* audit" in existing §715.7(c) as an audit option for credit unions with less than $500 million in assets?

The "Supervisory Committee Guide audit" option is a benchmark of minimum procedures that should be performed annually by either the Supervisory Committee or an outsourced licensed party. It has considerable value to small credit unions (those under $40 million in assets) when properly performed as it provides findings related to many internal control areas and results in a credible verification of supporting records for a credit union's recorded key assets, liabilities and equity accounts.

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The enforcement however, of ensuring the minimum procedures are either adequately done by the Committee or outsourced, is not being adequately performed. Some states piggybacking their audit requirements on Reg. 715 have state regulators accepting audit performances falling significantly short of the "minimum procedures" acceptable audit requirements.

In addition in six years of performing these engagements I have only seen one examination report recommendation to include in the subsequent years scope an item not on the core procedures but significant to that credit union. For all credit unions selecting this annual audit option the regulatory examination should evaluate the engagement letter and report of procedures and findings to ensure the minimum procedures, as applicable, have been completed and provide input on expansion of procedures to any other areas deemed key to the credit union.

This audit option also has value in select engagements where, because of limited equity of the credit union or other regulatory compliance or contingency issues, an opinion audit is either not obtainable due to engagement risk, or is not desired due to the credit union's, regulator's, or credit union's legal counsel not wanting to disclose in the footnotes the credit union's contingency risks in the event their disclosure becomes a self-fulfilling prophecy.

17. Should part 715 require credit unions that obtain a financial statement audit and/or an "attestation on internal controls" (whether as required or voluntarily) to forward a copy of the auditor's report to NCUA? If so, how soon after the audit period-end? If not, why not?

These copies are readily available at the credit union for the examination team, or the examiner assigned to the credit union can request them to be forwarded to him/her by the credit union upon their issuance. If copies were to be forwarded to NCUA they could be scanned in and stored electronically. These could subsequently be forwarded to the assigned field examiner prior to the examination. Forwarding report copies to NCUA within 30 days of issuance and delivery to the credit union would be reasonable. The current deadline to deliver audit reports to the credit union is 120 days from the effective date. Setting a 150 day delivery deadline for receipt at NCUA, subject to requested waivers due to unique situations, should encourage enhanced wrap-up of engagements.

18. Should part 715 require credit unions to provide NCUA with a copy of any management letter, qualification, or other report issued by its external auditor in connection with services provided to the credit union? If so, how soon after the credit union receives it? If not, why not?

These copies are also readily available at the credit union for the examination team or the examiner assigned to the credit union can request them to be forwarded to him/her by the credit union upon their issuance. If NCUA was to request them to be sent in they also could be scanned in and stored electronically. They could be subsequently forwarded to the assigned field examiner prior to the examination. Forwarding them to NCUA, along with management's response, within 60 days of issuance and delivery to the credit union would be reasonable. The current deadline to deliver the audit report and letter to the credit union is 120 days from the effective date. Setting a 180 day delivery deadline for receipt of management letters with anticipated responses at NCUA, subject to requested waivers due to unique situations, should be adequate. It should be acknowledged that requiring the comment letters to be sent to the regulators, even though they have always been accessible to them, will increase the political nature of the letters and result in the communication of many items currently being documented in a letter being instead communicated verbally with the documentation of that communication being recorded in a work paper file memo.

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19. If credit unions were required to forward external auditors' reports to NCUA, should part 715 require the auditor to review those reports with the Supervisory Committee before forwarding them to NCUA?

I believe it is the general practice of LarsonAllen to review the reports, regardless of the audit option selected, with the Supervisory Committee.

udit Options, Reports and Engagements (Continued)

!0. Existing part 715 requires a credit union's engagement letter to prescribe a target date of 120 days after the audit period-end for delivery of the audit report. Should this period be extended or shortened? What sanctions should be imposed against a credit union that fails to include the target delivery date within its engagement letter?

The current 120 day target date is generally fine. If it was to be changed it should be moved to 150 days to reduce the number of waivers that need to be requested due to engagement wrap-up issues. The field examiner should evaluate the engagement letter content as well as other aspects of the Supervisory Committee performance when conducting the "management" portion of the CAMEL evaluation.

1. Should part 715 require credit unions to notify NCUA in writing when they enter into an engagement with an auditor, and/or when an engagement ceases by reason of the auditor's dismissal or resignation? If so in cases of dismissal or resignation, should the credit union be required to include reasons for the dismissal or resignation?

From an auditor's perspective turnover of auditors happens too frequently due to the focus on one to three year engagements. The constant turnover occurring at some credit unions results in credit union management and supervisory committees not developing consultative relations with the audit firms and thus finding themselves without valued, independent advisors when needed.

Notifying NCUA each time a new auditor is selected seems excessive, especially if NCUA is ultimately going to receive the audit reports which reflect the auditor change. However dismissal, or resignation, of an engaged auditor prior to the engagement being completed or report issued is a red flag that should require disclosure to the appropriate regulatory agency whether NCUA or a state credit union division. The credit union, with their notice, should present their perspective as to the events surrounding the resignation or dismissal.

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22. **NCUA recently joined in the final *Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters*, 71 FR 6847 (Feb. 9 2006). Should credit union Supervisory Committees be prohibited by regulation from executing engagement letters that contain language limiting various forms of auditor liability to the credit union? Should Supervisory Committees be prohibited from waiving the auditor's punitive damages liability?**

The Federal Financial Institutions Examination Council (FFIEC) Interagency Advisory has taken the position that limiting liability of the auditor impacts independence of the auditor. The AICPA issued on September 15, 2005 an Exposure Draft titled "Omnibus Proposal of Professional Ethics Division Interpretations and Rulings" addressing several of the issues raised by the earlier Draft position of the FFIEC on this topic. The AICPA exposure draft concurs with the FFIEC on several issues. The Professional Ethics Executive Committee (PEEC) in the AICPA draft exposure has taken the position that they believe "a limitation of liability agreement, in which a member would not be liable to a client for punitive damages, would not impair the member's independence provided the member remained liable to the client for actual damages". The PEEC "also agreed that any agreement to limit or exclude punitive damage claims brought by lenders, shareholders, or other nonclient third parties should not be permitted and accordingly, independence would be impaired if a member enters into an agreement to be indemnified from third-party claims for punitive damages".

Subsequent to September 15, 2005 all audit engagement letters we have issued to credit union clients have attempted to meet concerns of both the FFIEC and the PEEC.

As the PEEC has pointed out if clients (Supervisory Committees) waive liability of the auditor for punitive damages the auditor is still liable for actual damages. Specifically the auditor remains exposed to clients, and also to lenders, shareholders, and other nonclients, for damages for any actual harm caused. As noted by the PEEC, actual damages can be significant, equaling hundreds of times (or more) the fees generated in connection with the engagement.

I hope you find my observations and comments to be useful.

Respectively Yours,

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